

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105

**Section 2361. CONSIDERATION OF LOSSES AND LOSS EXPOSURE IN
RESIDENTIAL PROPERTY INSURANCE RATING AND UNDERWRITING**

INITIAL STATEMENT OF REASONS

File No. RH03031129

July 22, 2003

The California Insurance Commissioner will hold public hearings to consider adopting Title 10, California Code of Regulations, Chapter 5, Subchapter 3, Article 7.2, Section 2361. The proposed regulation is entitled: Consideration of Losses and Loss Exposure in Residential Property Insurance Rating and Underwriting.

This regulation does not purport, nor is it intended, to do the following: place any new constraint on insurer use of loss history or credit related databases or require insurers to offer policies of insurance on risks they would not, following company underwriting and eligibility guidelines, ordinarily insure.

STATEMENT OF SPECIFIC PURPOSE

The following are statements of specific purpose and effect of each subsection of the proposed regulation including the rationale for the determination that each subdivision is reasonably necessary to carry out the purpose for which it is proposed. The subject matter of the proposed regulation is insurer consideration of losses and loss exposure in residential property insurance rating and underwriting. The proposed regulation is designed to address residential property / homeowners insurance availability and unfairly discriminatory underwriting in California.

A convergence of forces and unforeseen circumstances has come together in California to create a crisis in the residential property insurance market. While there are laws specific to insurance rating and underwriting that address cancellation, nonrenewal and eligibility for homeowners insurance, both the insurance industry and the insurance consuming public are unclear as to the exact application of these laws. This regulation is necessary to define, clarify and make specific the application of these laws in California.

By defining certain terms and providing concrete examples the proposed regulation is necessary to clear up any ambiguity in this area of the insurance law.

Proposed California Code of Regulations section 2361(a) - Adopt

The proposed subsection states that proposed California Code of Regulations (CCR) section 2361, subsections (a) through (f) apply to residential property risks subject to California Insurance Code (CIC) section 675. The purpose of this subsection is to define the scope and applicability of proposed CCR §2361.

Proposed California Code of Regulations section 2361(b) - Adopt

This proposed subsection sets forth definitions for the terms used substantively in the section. The purpose of this proposed subsection is to set forth the scope and applicability of the proposed section by providing that the definitions apply when an insurer considers losses or loss exposure in residential property insurance rating and underwriting. This proposed subsection is necessary to identify the definitions as used substantively in the text of the proposed regulation.

Proposed California Code of Regulations section 2361(b)(1) - Adopt

This proposed subsection defines the term “substantial relationship to loss exposure” by providing that a substantial relationship to the loss exposure exists when a hazard, physical condition, or liability exposure creates a material and identifiable effect on the likelihood of a covered loss. The purpose of this proposed subsection is to provide a consistent definition of the term “substantial relationship to loss exposure.”

The Commissioner believes that the term “substantial relationship to risk of loss exposure” has been the cause of some confusion for the insurance industry. This confusion is in part the source of a lack of availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other Insurance Code provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is necessary to define the term “substantial relationship to risk of loss exposure” in a clear and concise manner to better facilitate insurance industry understanding of the meaning of the term. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(2) - Adopt

This proposed subsection defines the term “increased risk of loss” by providing that an increased risk of loss will exist when a property or liability hazard or physical condition is identified or discovered which both bears a substantial relationship to the loss exposure and presents a greater likelihood of future loss than if the hazard or condition did not exist. The purpose of this proposed subsection is to provide a consistent definition of the term “increased risk of loss”

The Commissioner believes that the term “increased risk of loss” has been the cause of some confusion for the insurance industry. This confusion is in part the source of a lack of availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with

enforcing Proposition 103 and all other Insurance Code provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is necessary to define the term “increased risk of loss” in a clear and concise manner to better facilitate insurance industry understanding of the meaning of the term. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(3) - Adopt

This proposed subsection provides a definition for “fully remedied or otherwise resolved.” The purpose of this proposed subsection is to set forth definitions for the terms used substantively in the section. The subsection sets forth the scope and applicability of the proposed section by providing that the definitions apply when an insurer considers losses or loss exposure in residential property insurance rating and underwriting.

This proposed subsection specifically defines the term “fully remedied or otherwise resolved” and is necessary to make clear the meaning of the term as used substantively later in the regulation.

Proposed California Code of Regulations section 2361(b)(3)(i) - Adopt

This proposed subsection provides that a fully remedied or otherwise resolved loss or loss exposure exists when the property has been returned to a state of repair that is equal or superior to the condition existing prior to the occurrence or condition which created the increased risk of loss.

The Commissioner believes that the term “fully remedied or otherwise resolved” needs to be defined in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to define the term in a clear and concise manner and is necessary to better facilitate insurance industry understanding of the meaning of the term. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(3)(ii) - Adopt

This proposed subsection provides that a fully remedied or otherwise resolved loss or loss exposure exists when the liability hazard insured against has been reduced to equal or below the level existing prior to the loss or loss exposure.

The Commissioner believes that the term “fully remedied or otherwise resolved” needs to be defined in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to define the term in a clear and concise manner and is necessary to better facilitate insurance industry understanding of the meaning of the term. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(3)(iii) - Adopt

This proposed subsection provides that a fully remedied or otherwise resolved loss or loss exposure exists when the increased risk of loss has been entirely eliminated because the property is no longer owned by the insured, the liability hazard is no longer the responsibility of the insured, the policy no longer provides coverage for that exposure, or the condition that caused the increased risk of loss has been removed.

The Commissioner believes that the term “fully remedied or otherwise resolved” needs to be defined in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to define the term in a clear and concise manner and is necessary to better facilitate insurance industry understanding of the meaning of the term. Where the term is substantively applied the intent is to make specific the meaning of the term and its relationship to other applicable and relevant insurance laws.

Proposed California Code of Regulations section 2361(b)(4) - Adopt

This proposed subsection defines the term “adverse underwriting decision” by referring to California Insurance Code Section 791.02. The purpose of this proposed subsection is to provide a consistent definition for “adverse underwriting decision.”

This proposed subsection with the definition and reference is necessary to ensure the entities to which this regulation will apply have a clear and concise understanding of the use and application of the term.

Proposed California Code of Regulations section 2361(c) - Adopt

This proposed subsection provides that where an adverse underwriting decision is based on losses or loss exposure, when otherwise allowed by law, the adverse underwriting decision shall be based upon conditions of the individual risk which bear a substantial relationship to the loss exposure and which present an increased risk of loss when compared to other risks eligible for coverage under the insurer's underwriting guidelines.

This proposed subsection also provides that an insurer shall not base, in whole or in part, an adverse underwriting decision on losses or loss exposures that have been fully remedied or otherwise resolved. The proposed subsection provides that losses or loss exposures that have been fully remedied or otherwise resolved are no longer substantially related to the risk of loss.

This proposed subsection is necessary in order to make clear the application of this section, and to also make clear how the various defined terms interact. The purpose of this proposed subsection is to promote proper underwriting in the homeowners lines of insurance. This proposed subsection is also necessary in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

The purpose of this proposed subsection is to make clear that there can be no justification for basing an adverse underwriting decision on losses or loss exposures which no longer exist because they bear no relations to the risk of loss.

This proposed subsection is necessary to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

Proposed California Code of Regulations section 2361(d) - Adopt

This proposed subsection provides that an insurer shall not base an adverse underwriting decision, in whole or in part, on an inquiry regarding coverage, unless a hazard or condition is identified which both bears a substantial relationship to the loss exposure and presents an increased risk of loss.

The purpose of this proposed subsection is to make clear that mere inquiries cannot be used to form the basis of an adverse underwriting decision because inquiries bear no relationship to the future risk of loss. An inquiry about mold coverage does not cause the house to get toxic mold.

This proposed subsection is necessary to make clear the application of this section, and to also make clear how the various defined terms interact. This proposed subsection is necessary to promote proper underwriting in the homeowners lines of insurance. This proposed subsection is also necessary in order to avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is necessary to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

Proposed California Code of Regulations section 2361(e) - Adopt

This proposed subsection provides that that an insurer shall gather adequate information to determine that an increased risk of loss exists before a loss, loss exposure, or an inquiry with respect to coverage can be used as grounds for an adverse underwriting decision. The proposed subsection adds that in accordance with California Insurance Code Section 791.12, an insurer cannot rely solely on information obtained from an insurance-support organization. The proposed section also provides that if the information is from an insurance support-organization, the insurer shall obtain further relevant information in addition to the material obtained from the insurance-support organization. Sources for this information may include the insurance application or supplemental application, telephone inquiry, written inquiry, and physical inspection.

The purpose of this proposed subsection is to make clear that an adverse underwriting decision must be based on exposure to loss, therefore an insurer must gather sufficient information to make a reasonable determination about what the actual loss exposure is before using that loss exposure to rate the policy.

This subsection is necessary in order to make clear the application of this section, and to also make clear how the various defined terms interact. This section is necessary to promote proper underwriting in the homeowners lines of insurance. This section is also necessary in order to

avoid confusion that may impact availability in the homeowners insurance market. The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition 103 and all other CIC provisions. Proposing this definition, and the other definitions contained herein, is necessary to ensure homeowners insurance remains available in California.

This proposed subsection is designed to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

Proposed California Code of Regulations section 2361(f) - Adopt

This proposed subsection provides that when an insurer makes an adverse underwriting decision, the insurer shall maintain documentation detailing the hazards or physical conditions which created an increased risk of loss and how this information was considered in policy rating or underwriting. The proposed subsection adds that this documentation shall be maintained during the time in which the policy is in force and otherwise as required by law.

This proposed subsection is necessary to make clear the application of this section, and to also make clear how the various defined terms interact. The purpose of this proposed subsection is necessary to promote proper underwriting in the homeowners lines of insurance. This proposed subsection is also necessary to enable CDI to verify compliance with the insurance laws.

This proposed subsection is necessary to make application of the section clear and concise to better facilitate insurance industry understanding of the meaning of the term.

IDENTIFICATION OF STUDIES AND REPORTS

The following is a list of media reports reviewed by CDI personnel during the drafting phase of this regulation.

1. Max, Sarah. *The Great Insurance Crisis*. CNN Money, January 14, 2003.
1. McAllister, Sue. *Finding Property Insurance Becomes More Challenging*. San Jose Mercury News, December 2, 2002.
2. O'Reilly, Kevin. *Hard Market Hits California Homeowners*. Insurance Journal, April 7, 2003.
3. Benda, David. *Static Over Statistics*. Record Searchlight, June 01, 2003.
4. McSwain, Dan. *State Action Planned in Insurance Crisis*. North County Times, February 01, 2003.
5. Harney, Kenneth. *Risky Business – Calling Your Insurance Agent*, San Francisco Chronicle. April 27, 2003.
6. Lloyd, Carol. *Homeowner's Insurance Springs a Leak Water Damage Claims Causing a Flood of Cancelled Coverage*. SF Gate, February 18, 2003.

7. Editorial. *Access To Insurance and Soaring Premiums Are Barriers To Homeownership, Says NAR President*. Real Estate News, July 07, 2003.
8. Unknown. *Insurance Commissioner Defends Crackdown*. Sacramento Business Journal, June 06, 2003.
9. Sandra Hughes. *Insurance Industry Blacklist*. CBSNews.com, January 2, 2003

CDI also relied on 2000 OAL Determination No. 15 dated October 24, 2000, in drafting this regulation.

CDI did not rely upon any technical, theoretical and/or empirical study, report or similar document in proposing this regulation.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of the proposed regulation would not mandate the use of specific technologies or equipment.

CONSIDERATION OF ALTERNATIVES

Performance standards were considered. The objective identified was fairness in residential property underwriting. However, one of the reasons performance standards were rejected was that the criteria by which the attainment of this objective was to be evaluated would necessarily be impracticable, vague or otherwise ineffective given the abstract nature of the objective.

Performance standards were considered and rejected because it was decided that compliance with performance standards would be much more costly than compliance with prescriptive standards in the context of residential property underwriting. Prescriptive standards are more efficient in this context because, unlike performance standards, they provide the affected businesses a means of determining with certainty and exactitude whether or not they are in compliance, and if they are not, how to achieve compliance. Additionally it was felt that performance standards would foster costly litigation.

IMPACT ON SMALL BUSINESS

The Commissioner has determined that the proposed regulations do not affect small businesses.

Date: July 22, 2003

JOHN GARAMENDI
Insurance Commissioner

By: _____
Donald P. Hilla
Senior Staff Counsel